No. 10983

In the United States Circuit Court of Appeals for the Ninth Circuit

SUSAN AVERY JONES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The opinion of the Tax Court of the United States (R. 12–18) is not reported.

JURISDICTION

This case involves the income tax liability of Susan Avery Jones for the calendar year 1940. The notice of deficiency was mailed on November 10, 1942 (R. 6), and the petition for redetermination was filed with the Tax Court on February 2, 1943 (R. 1), pursuant to Section 272 (a) of the Internal Revenue Code. The decision of the Tax Court was entered on October 10, 1944. (R. 18.) The petition for review was filed on January 5, 1945. (R. 19–23.) The jurisdiction of

this Court rests upon Sections 1141–1142 of the Internal Revenue Code.

QUESTION PRESENTED

Taxpayer and her husband purchased certain real estate for purposes of building a personal dwelling house on it. They subsequently abandoned this intention and improved the land as a residential site in order to facilitate its sale and to minimize any loss thereon. Was the loss sustained upon the sale of the real estate in 1940 deductible under Section 23 (e) (2) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

These will be found in the appendix, *infra.*

STATEMENT

The facts as found by the Tax Court may be summarized as follows (R. 12–14):

In 1927, taxpayer and her husband, a highly successful author and scenario writer, entered into a contract for the purchase of certain real estate in Beverly Hills, California, hereinafter referred to as Tiger Tail. The purchase price was $16,500. Payments were completed in May 1931 and at that time taxpayer and her husband received a deed to this property as joint tenants. The lot was irregularly shaped and at the time of purchase, taxpayer and her husband were advised by the broker that they would have no difficulty in buying an adjoining lot at a low price, which would fill out the tract to form a rectangular piece. Taxpayer and her husband pur-

chased this property intending to build a home thereon. When the payments were finally completed and the deed received, taxpayer's husband commenced negotiations for the so-called corner lot which he felt was needed to complete the tract. The owner of this lot was a non-resident and when his price for the property was made known, Jones decided immediately that he would not pay it, but that he would build his home elsewhere. He asked his real estate broker to list Tiger Tail for sale and very soon thereafter purchased a residence on Sunset Boulevard, and occupied it with taxpayer as their home. During the period from June 1931 to 1937 taxpayer and her husband purchased additional ground for the Sunset Boulevard home and eventually in 1937 razed the original building and erected a palatial mansion with extensive landscaping, elaborate dog kennels, a swimming pool and other improvements found only in the most expensive homes. The total cost was approximately $250,000. Its original cost was not in excess of $27,500. (R. 12–13.)

When taxpayer and her husband purchased the home on Sunset Boulevard they abandoned any intention to build their future home on Tiger Tail. During 1932 and 1933 they spent large sums of money improving it as a residential site, which included installations of a sprinkler system, a driveway, the building of a road along one side of the property, and other extensive improvements, including the planting of trees and shrubs. This was done in an effort to make the property more salable and to minimize their

loss in this connection. No buildings were ever erected and the property never produced any income. (R. 13–14.)

On several occasions Jones was offered $10,000 for Tiger Tail and each time he refused to accept. He had become so enraged over his inability to acquire the small lot needed to complete Tiger Tail that he refused to sell unless he got his money out of it. On several occasions real estate men discussed with Jones the possibility of trades and exchanges for ranches but nothing ever came of these discussions. After Jones' death in September 1940 taxpayer sold Tiger Tail for $7,500. The value of Tiger Tail in May or June, 1931, when taxpayer and her husband purchased the home on Sunset Boulevard, was $16,500. (R. 14.)

The Tax Court held that neither the listing of the property for sale nor the expenditure of money and effort to promote its sale constituted a transaction entered into for profit for purposes of deducting the loss sustained under Section 23 (e) (2) of the Internal Revenue Code. (R. 14.) From this decision taxpayer appeals.

SUMMARY OF ARGUMENT

A loss on the sale of residential property purchased for use as the taxpayer's personal residence is not deductible. Although the loss is allowable where the property has previously been devoted exclusively to the production of taxable income, as where it is rented, improvements made for the express purpose of facilitating the sale and minimizing any loss thereon do not convert the transaction into one entered into

for profit. These words must be taken in their usual sense, and activities designed to minimize the loss of money are sufficiently dissimilar from those directed toward the making of profits to warrant the exclusion by the Tax Court of the former from a deduction section of the statute. Insofar as the Treasury Regulations have consistently provided that the residential property must be appropriated to income producing purposes before a transaction entered into for profit is effected, they are a correct and reasonable construction of the statute and have the force and effect of law. Under taxpayer's theory, every sale of a personal asset which involves the expenditure of money in preparation thereof, would be converted into a transaction entered into for profit and the distinction in the statute between personal and profit transactions would be obliterated. Moreover, even assuming that remodeling the land to devote it exclusively to rental or income producing purposes would constitute a conversion without income actually being produced, nothing taxpayer and her husband did to the property was unequivocally inconsistent with their use of the land for residential purposes or made it impossible for them to use it for any definite period of time. At any time after the improvements were made taxpayer and her husband could have erected their home on the land and have had the benefit of their expenditures. Under any analysis, therefore, taxpayer was correctly denied the deduction on the ground the loss on the sale of the property in 1940 was not incurred in a transaction entered into for profit.

ARGUMENT

The loss on the sale of the Tiger Tail property in 1940 was not incurred in a transaction entered into for profit

The issue in this case is a narrow one. Taxpayer and her husband admittedly purchased the Tiger Tail property in order to build their personal home on it. (R. 13.) It is conceded (Pet. Br. 11) that after they abandoned this intention, had they then merely listed the property with a broker for sale, the loss on the subsequent sale would have been a personal one (*Phipps* v. *Helvering,* 124 F. 2d 292 (App. D. C.)), and not deductible under Section 23 (e) (2) of the Internal Revenue Code (Appendix, *infra*) as one incurred in a transaction entered into for profit (*Morgan* v. *Commissioner,* 76 F. 2d 390 (C. C. A. 5th), certiorari denied, 296 U. S. 601; *Rumsey* v. *Commissioner,* 82 F. 2d 158 (C. C. A. 2d), certiorari denied, 299 U. S. 552; *Gevirtz* v. *Commissioner,* 123 F. 2d 707 (C. C. A. 2d); *Robinson* v. *Commissioner,* 134 F. 2d 168 (C. C. A. 3d)). The factor alleged to remove the instant case from the pale of the foregoing authorities is the expenditure of considerable sums of money to improve the property as a residential site. (Pet. Br. 11.) It is the Government's contention, however, that where, as here, the improvements were made for the express purpose of facilitating the sale of the land and minimizing any loss thereon (R. 13–14) and did not change the use to which the property could be put, they did not effect a conversion of the transaction into one entered into for profit.

At the outset it should be noted that appellate review of this issue is definitely restricted. Whether

a transaction is entered into for profit is fundamentally a question of intention, and the finding of the Tax Court against taxpayer is entitled to the finality indicated by *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231. See *Cohen* v. *Commissioner* (C. C. A. 2d), decided March 23, 1945 (1945 C. C. H. par. 9240). The words "any transaction entered into for profit" are not a technical phrase or one of art. *Heiner* v. *Tindle,* 276 U. S. 582. They must therefore be taken in their usual sense (*Heiner* v. *Tindle*) and when so taken, it is clear that activities designed to minimize the loss of money are decidedly different from those directed towards the making of profits. See *Bowers* v. *Kerbaugh-Empire Co.,* 271 U. S. 170. They may not be the antithesis of each other, but surely the Tax Court cannot be convicted of a "clear cut" error of law in holding them sufficiently dissimilar to warrant exclusion of the former from the purview of a deduction section of the statute. See *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435; *Robinson* v. *Commissioner, supra.*

Moreover it is submitted that the rationale of Section 23 (e) (2) of the Internal Revenue Code as construed by the courts leads inescapably to the conclusion that taxpayer was correctly denied the deduction sought. A loss on the sale of residential property purchased for use as the taxpayer's personal residence is not deductible. *Phipps* v. *Helvering, supra;* Section 19.23 (e)–1, Treasury Regulations 103, Appendix, *infra.* A change of character of the property by devoting it exclusively to the production of taxable income, as where the property is rented, converts the

loss on the subsequent sale, however, to an allowable deduction. *Heiner* v. *Tindle, supra.* Insofar as the Treasury Regulations, from Article 171 of Treasury Regulations 75 to the present (see Section 19.23 (e)–1 of the Treasury Regulations 103), have consistently followed the pronouncement of the *Tindle* case that the property must be "appropriated to income producing purposes", they are a correct and reasonable construction of the statute and have the force and effect of law. *Helvering* v. *Winmill,* 305 U. S. 79; *Helvering* v. *Reynolds,* 306 U. S. 110. Yet under taxpayer's theory, almost every sale of a personal asset which had never been appropriated to income producing purposes, would be converted into a transaction entered into for profit. For almost every sale necessitates some preparation involving the expenditure of money. Thus, if in order to sell his home an owner has a title search made, or the roof repaired, or prior to selling his personal automobile, has the fenders straightened or body painted, taxpayer would have to say that both the house and automobile were sold in a transaction entered into for profit; whereas in truth, all that the owner wanted, after he finished his personal use of the house and automobile was to realize from the sale as much money as possible. But this is true of every sale and the distinction in the statute between personal and profit transactions would be obliterated. In *Weir* v. *Commissioner,* 109 F. 2d 996, the Third Circuit stated the issue in this manner (p. 998):

> If you intend to benefit us by producing taxable profits, you may take your loss, but if you

> don't intend to so benefit us, you cannot deduct your losses and we, furthermore will tax you on your windfalls. * * *

The emphasis upon the production of taxable income was not haphazard. If a personal residence is rented out, the Government has the opportunity of taxing the net income, and as compensation for the opportunity allows a loss deduction on the sale. But the loss is not allowed when there is merely an attempt to rent the premises no matter how sincere or vigorous. *Rumsey* v. *Commissioner, supra; Gevirtz* v. *Commissioner, supra; Phipps* v. *Helvering, supra.* This is so not only because of the absence of the income producing feature, but also because of the ease with which the owner may resume his original use. *Schmidlapp* v. *Commissioner,* 96 F. 2d 680 (C. C. A. 2d). Nothing taxpayer and her husband did to the Tiger Tail property in 1932 and 1933, when the alleged conversion took place (Pet. Br. 7), was unequivocally inconsistent with their use of the land for residential purposes for any definite period of time. (R. 13, 17.) They may have abandoned the idea of settling there in 1931, but just as the taxpayers in the *Morgan* and *Rumsey* cases, *supra,* they might have resumed their residential uses at any time by a mere change of mind Assuming, *arguendo,* that remodeling the land to devote it exclusively to rental or income producing purposes would constitute a conversion without income actually being produced (see *Morgan* v. *Commissioner, supra; Rumsey* v. *Commissioner, supra*), it is clear that here, as the Tax Court pointed out (R. 17), taxpayer and her husband at any time after the improve-

ments were made could have erected their home on Tiger Tail and have had the benefit of their expenditures. It was not until 1937 that the palatial mansion on Sunset Boulevard was built. (R. 13.) Between 1933 and 1937, had taxpayer's husband been able to purchase the lot adjoining the Tiger Tail property at a figure suitable to him, nothing restricted him from making his home there. And the building of the new home in 1937 without doing anything to the Tiger Tail property could not effect a conversion of the latter. *Phipps* v. *Helvering, supra.* Under any analysis, therefore, taxpayer was correctly denied the deduction on the sale of the property in 1940.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted.

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May 1945.

APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

*   *   *   *   *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

*   *   *   *   *

(26 U. S. C. 1940 ed., Sec. 23.)

Treasury regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (e)-1. *Losses by individuals.*—* * *

*   *   *   *   *

A loss on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible. If, however, property so purchased or constructed is prior to its sale rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss from the sale of the property, computed as provided in section 111, is, subject to the limitations provided in section 117, an allowable deduction in an amount not to exceed the excess of the value of the property at the time it was appropriated to income-producing purposes (with proper adjustment for depreciation) over the amount realized from the sale.

Example (1): Residential property was purchased by a taxpayer in 1929 for use as his per-

sonal residence at a cost of $25,000, of which $15,000 was allocable to the building. The property was so used by the taxpayer until January 1, 1936. From that date to January 1, 1939, when the property was sold, it was rented by the taxpayer. The fair market value of the property at the time it was rented on January 1, 1936, was $22,000, of which $12,000 was allocable to the building. The building had an estimated life of 20 years on January 1, 1936. The property was sold on January 1, 1939, for $16,000. The loss from the sale allowable as a deduction, except as limited by section 117, is $4,200, computed as follows:

Cost of property in 1929	$25,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $12,000, value of building when converted to business use)	1,800
	23,200
Selling price of property	16,000
Loss computed as provided in section 111	7,200
Value of property at time it was rented on January 1, 1936	22,000
Less proper adjustment for depreciation	1,800
	20,200
Selling price of property	16,000
Portion of $7,200 loss which is deductible except as limited by section 117	4,200

Example (2): If, under the circumstances set forth in example (1), the property had been purchased at a cost of $20,000, of which $10,000 was allocable to the building, but otherwise the facts assumed are the same, the deductible loss, except as limited by section 117, is $2,500, computed as follows:

Cost of property in 1929	$20,000
Less depreciation allowed (not less than amount allowable) in respect of the building (depreciation for 3 years at 5 percent based on $10,000, cost of building)	1,500
	18,500
Selling price of property	16,000
Loss computed as provided in section 111	2,500
Deductible loss, except as limited by section 117	2,500

* * * * *

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